

CAPITAL REVENUE FORECAST

MAJOR CAPITAL REVENUES

The major revenues that support the City of San José's capital programs are bond proceeds, grants, transfers between funds, and a number of taxes levied on construction and property resale (conveyance) activity. This document provides a five-year forecast for the following taxes and fees: Construction and Conveyance Tax; Building and Structure Construction Tax; Construction Excise Tax; Residential Construction Tax; Sanitary Sewer Connection Fee; and the Storm Drainage Connection Fee.

As shown below, these revenues are expected to generate \$247.9 million over the next five years, an increase of 14% over the 2006-2010 Adopted Capital Improvement Program (CIP) estimates. The Construction-Related Revenue chart included at the end of this section provides a year-by-year comparison of this forecast with 2006-2010 Adopted CIP.

Forecast Comparison Summary

(\$ in Thousands)

	2006-2010 CIP	2007-2011 Forecast	Difference	Change
Construction and Conveyance Tax	94,000	119,000	25,000	27%
Building and Structure Construction Tax	44,765	49,952	5,187	12%
Construction Excise Tax	69,032	69,428	396	1%
Residential Construction Tax	985	1,214	229	23%
Sanitary Sewer Connection Fee	5,571	5,654	83	1%
Storm Drainage Connection Fee	2,586	2,624	38	1%
TOTAL	216,939	247,872	30,933	14%

For the Construction and Conveyance Tax, the Conveyance Tax portion (property transfers) account for 98% of the total collections. In recent years, the strength of the local real estate market has led to double-digit growth in this category that has far exceeded expectations. When the 2006-2010 Forecast was developed, it was assumed that this extremely high level of activity would not be sustained and that collections would begin to fall. Through the first part of 2005-2006, collections still experienced significant growth over the prior year. However, in recent months, the rate of grow has started to slow and data for the month of February 2006 shows the first decline from the prior year since January 2003. While the softening of the real estate market is now starting to impact Construction and Conveyance Tax collections, receipts are still expected to normalize at a slightly higher annual collection level than previously forecasted. As a result, this category is expected to generate \$119 million over the next five-years, an increase of \$25 million over the 2006-2010 Adopted CIP estimates. The average annual collection level of \$23.8 million in the 2007-2011 Forecast, however, is still well below the actual collection levels in recent years that reached \$46.7 million in 2004-2005.

The capital revenue projections for the other taxes and fees described in this forecast are derived from construction activity estimates provided by the Planning, Building and Code Enforcement

MAJOR CAPITAL REVENUES (CONT'D.)

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Department. Each year the Planning, Building and Code Enforcement Department provides projections of activity for each of the three types of development (residential, commercial, and industrial) from which the revenues are derived. A more complete discussion of these estimates is provided in a technical report prepared by that department entitled "Development Activity Highlights and Five-Year Forecast (2006-2011)", which is attached as an appendix to this document.

Over the forecast period, construction activity is expected to remain relatively flat with valuation hovering around \$1 billion in each of the next five years. These assumptions are consistent with those presented in the 2006-2010 Forecast. Construction activity peaked in 2000-2001 at \$1.9 billion, followed by a sharp decline that reached a low point of \$751 million in 2003-2004. From that low point, a modest recovery occurred in 2004-2005 with growth of 15% in that year. A minimal amount of growth is expected in each year from 2005-2006 through 2007-2008, with activity leveling off in the out years of the forecast. Based on the construction activity estimates and a review of revenue collection patterns, an overall increase in the construction-related taxes and fees of \$5.9 million, or 4.8%, is expected when comparing the 2007-2011 Forecast to the 2006-2010 Adopted CIP estimates.

Each of the six revenue categories along with a discussion of the major construction activity trends are discussed in more detail below.

CONSTRUCTION AND CONVEYANCE TAX

The Construction Tax portion of the Construction and Conveyance Tax category is levied on most types of construction. For residential construction, the tax rate is based upon the number of units constructed and ranges from \$75 per unit located in a building containing at least twenty dwelling units to \$150 for a single-family residence. The commercial and industrial rate is eight cents per square foot of floor area constructed. The Construction Tax accounts for approximately 2% of the total Construction and Conveyance Taxes collected.

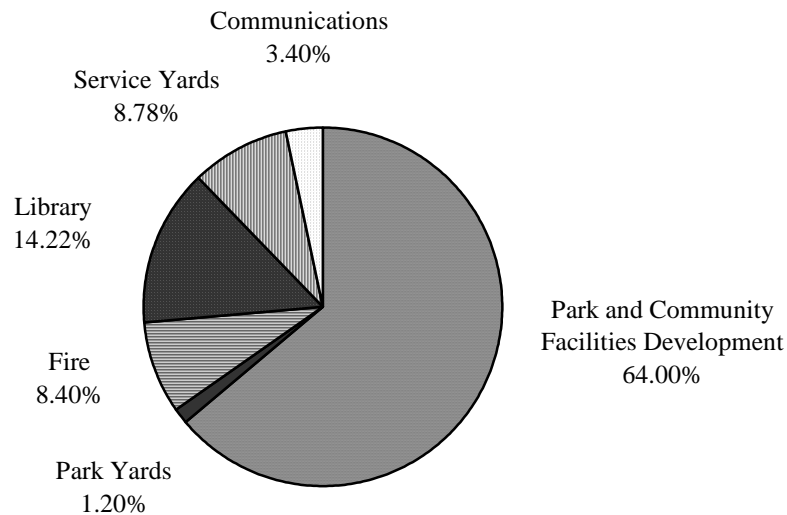
The Conveyance Tax portion of the Construction and Conveyance Tax category is imposed upon each transfer of real property where the value of the property exceeds one hundred dollars. The tax is imposed at a rate of \$1.65 for each \$500 of the value of the property. The Conveyance Tax accounts for approximately 98% of the total Construction and Conveyance Taxes collected.

Construction and Conveyance Tax receipts are allocated using the following distribution to capital programs.

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CONSTRUCTION AND CONVEYANCE TAX (CONT'D.)

Construction and Conveyance Tax Distribution



The combined proceeds from the Construction and Conveyance Tax may be used for facility acquisition, construction, equipment, furnishings, and limited operating and maintenance expenses.

Consistent with the Construction and Conveyance Tax Task Force recommendations adopted by the City Council in June 1989, the Park and Community Facilities Development portion of the estimated revenues, less non-construction costs and transfers to the General Fund, is allocated for all years of the forecast using a two-to-one ratio, with two-thirds of the proceeds going to neighborhood/district projects and one-third to city-wide projects. Per the current City Council policy, twenty percent of funds for neighborhood/district projects is set aside and equally allocated to meet special needs. The balance of the funds is then distributed based on a formula using the following criteria:

- neighborhood and community-serving park acres per 1,000 population;
- developed neighborhood and community-serving park acres per 1,000 population;
- square feet of neighborhood and community-serving center space per 1,000 population; and
- developed park acres and/or facilities in good condition per 1,000 population.

The five-year projection for Construction and Conveyance Tax revenue totals \$119 million, an increase of \$25 million from the \$94 million estimated in the 2006-20010 CIP. The Construction and Conveyance Tax revenue projections are based upon: 1) a review of prior year collection trends; 2) a review of year-to-date residential sales activity in San José; 3) a review of

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year-to-date tax receipts; and 4) projections of the future strength of the San José real estate market.

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CONSTRUCTION AND CONVEYANCE TAX (CONT'D.)

- **Prior Year Collection Trends**

Historically, Construction and Conveyance Tax revenues have been impacted by the ups and downs of the local economy. In the late 1980's, collections in this area were extremely strong, peaking at \$18 million in 1988-1989. In the first half of the 1990's, however, revenue fell precipitously with collections ranging from approximately \$9 million to \$11 million annually, reflecting the economic slowdown experienced at that time. In the latter half of the 1990's, healthy annual increases were again realized in this revenue category with growth skyrocketing from \$13.4 million in 1995-96 to a peak of \$31.6 million in 2000-2001. This tremendous growth was indicative of the economic gains during that period, marked by the stock market growth, low unemployment, and the gains in personal income. As economic conditions began to worsen, tax receipts in this area fell, experiencing a 17% decline in 2001-2002 to \$26.3 million and an additional 5.5% decline in 2002-2003 to \$24.8 million. Surprisingly, however, and contrary to our projections, this drop-off did not continue, even though the general economic conditions did not improve significantly. Far exceeding our projections, collections grew to \$38.2 million in 2003-2004 and reached a record setting high of \$46.7 million in 2004-2005.

- **2005-2006 Collections**

Although still relatively strong through the first half of this year, real estate activity is now beginning to show definite signs of the long expected slowdown. As an example, the number of property transfers for all types of residences has decreased by 13.2% through January when compared to the same period last fiscal year. Also, the median single-family home price in San José has continued to fall slightly over the last seven months from \$705,000 in June 2005 to \$635,000 in January 2006. (The latest median home price does, however, reflect an increase of 7.6% from \$635,000 in January 2005.) Finally, the amount of time it takes to sell a home is starting to increase, which is also a sign of a softening in the housing market. The average days on market has steadily grown from a low of 15 days in June 2005 to 45 days in January 2006.

Despite these signs of slowing in the real estate sector, Construction and Conveyance Tax collections in 2005-2006 have significantly exceeded expectations with collections of \$30.2 million through the first seven months, an increase of approximately 15% from the prior year. This growth, however, reflects extremely strong receipts in the first few months of the year, which have leveled off in recent months. Conveyance Tax receipts for the month of February 2006 actually fell almost 5% from the February 2005 collection level, marking the first decline since January 2003. It is still anticipated that Construction and Conveyance Tax receipts will end the year close to the record-setting levels of last year with estimated collections of approximately \$44 million. This assumes that collections for the remaining months of this fiscal year will fall approximately 25% from the extremely high collection levels experienced at the end of last fiscal year.

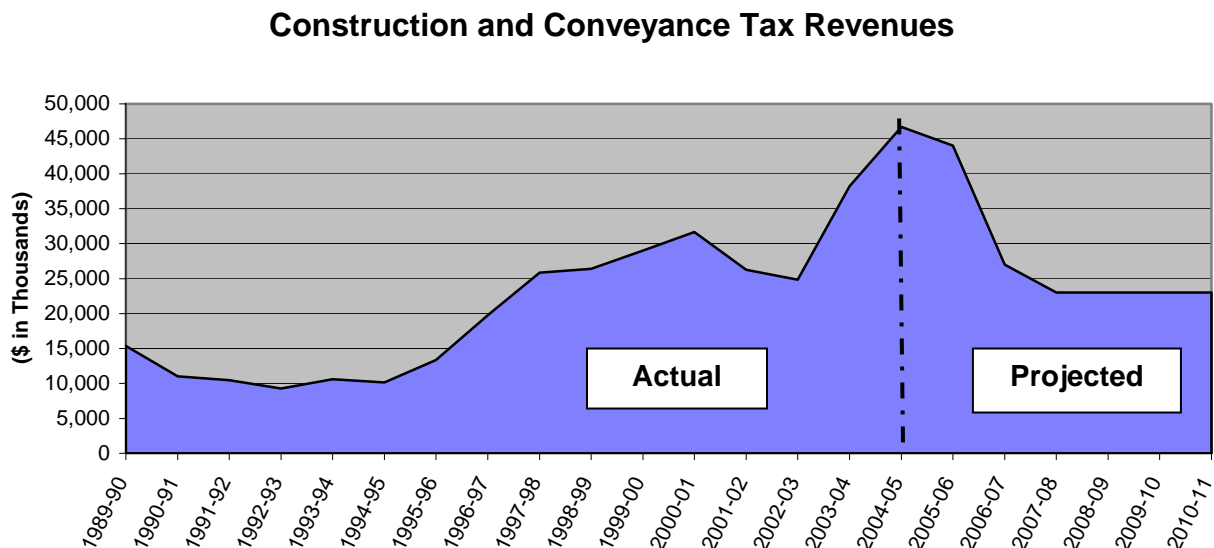
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CONSTRUCTION AND CONVEYANCE TAX (CONT'D.)

- **2007-2011 Collections**

The 2007-2011 Construction and Conveyance Tax revenue forecast is built on the assumption that collections will continue to reflect a relatively significant softening of the real estate market and fall to \$27 million in 2006-2007 and level off at \$23 million annually for each of the remaining years of the forecast. This forecasted collection level reflects what is believed to be a more sustainable level of ongoing housing resale activity.

The following graph illustrates the actual and projected revenues for the combined Construction and Conveyance Tax revenues:



CONSTRUCTION ACTIVITY PROJECTIONS

With the exception of the Construction and Conveyance Tax Fund, the capital revenues described in this forecast are construction-related taxes and fees. As described above, the Planning, Building and Code Enforcement Department has provided construction activity projections for each of the three types of development (residential, commercial, and industrial) from which the revenues are derived. These construction activity estimates are described in the technical report prepared by that department entitled “Development Activity Highlights and Five-Year Forecast (2006-2011)”, which is attached as an appendix to this document.

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CONSTRUCTION ACTIVITY PROJECTIONS (CONT'D.)

A summary of the Planning, Building and Code Enforcement Department construction activity projections and the corresponding revenue estimates are provided below. Due to the highly volatile nature of the construction and real estate markets, the reliability of the estimates can be expected to decline over the period of the forecast. As a result, for the final two years, the Planning, Building and Code Enforcement Department has held its projections constant. The Department intends these to be interpreted as “ball park” estimates of the most likely state of the local economy based on current information. As new information becomes available, these estimates will be refined. The Budget Office actively monitors changes in development activity and reports this information to the City Council through Monthly Financial Reports.

A. Residential Construction Activity

A significant portion of development-related revenue in San José has traditionally been generated by residential construction. Permit activity in 2004-2005 was moderate, with building permits issued for 3,293 new dwelling units. This represented an overall increase of 22% from the five-year low of 2,709 units issued in 2003-2004. In 2005-2006, the issuance of permits is expected to be experience a slight downturn, with an estimated 3,000 new units.

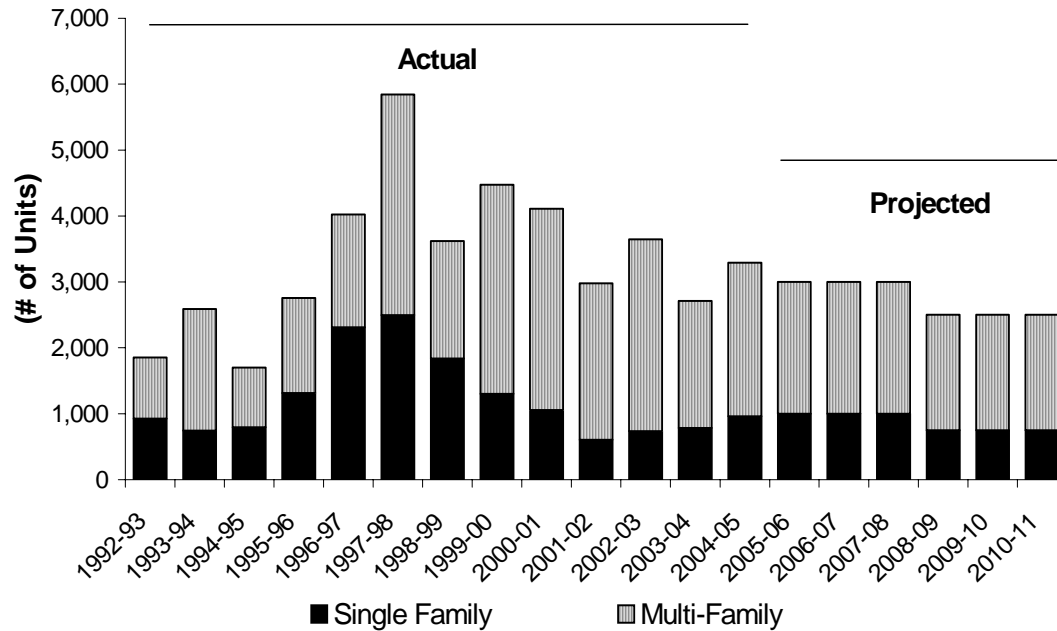
Residential construction activity is expected to generate 13,500 units over the five-year period, an average of 2,700 units per year. This activity level is consistent with the estimates included in the 2006-2010 Forecast and represents a slight increase from the annual estimates of 2,650 included in the 2005-2009 Forecast. This activity level, however, represents a significant decline from the actual levels experienced in recent years, which reached a high of 5,842 units in 1997-1998.

A total of 9,250 multi-family units are expected to be constructed over the next five years, which is consistent with the activity level projected in both the 2006-2010 Forecast and the 2005-2009 Forecast and down slightly from the 9,500 projected in the 2004-2008 Forecast. In this Forecast, 4,250 single-family dwellings are anticipated. This figure is consistent with the 2006-2010 Forecast and is somewhat higher than both the 2005-2009 and 2004-2008 Forecasts of 4,000 units and the 2003-2007 Forecast of 3,500 units, but is well below the 5,500 units projected in the 2001-2005 Forecast. The chart below shows the number of units, by housing type, anticipated in San José through 2010-2011.

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CONSTRUCTION ACTIVITY PROJECTIONS (CONT'D.)

Residential Construction Activity



B. Commercial Construction Activity

In 2004-2005, commercial construction activity totaled \$210 million, an increase from the 2003-2004 level of \$201 million but a drop of 73% from the peak reached in 2000-2001 of \$765 million. Planning staff expects commercial activity to experience moderate increases in 2005-2006, with permit valuation estimated to reach \$250 million.

Over the forecast period, commercial construction is expected to rebound somewhat with anticipated valuations of \$325 million in 2006-2007 and \$350 million for the remaining four years of the forecast (see the chart in section D below). The total commercial valuation projected in this forecast is \$1.7 billion, which is consistent with the previous five-year forecast. As discussed in the attached report provided by the Planning, Building and Code Enforcement Department, the outlook for commercial construction activity is reasonably good with the approved retail redevelopment of the GE property, pending applications for new Costco, Home Depot, and Lowe's outlets, and the growing popularity of mixed use type projects.

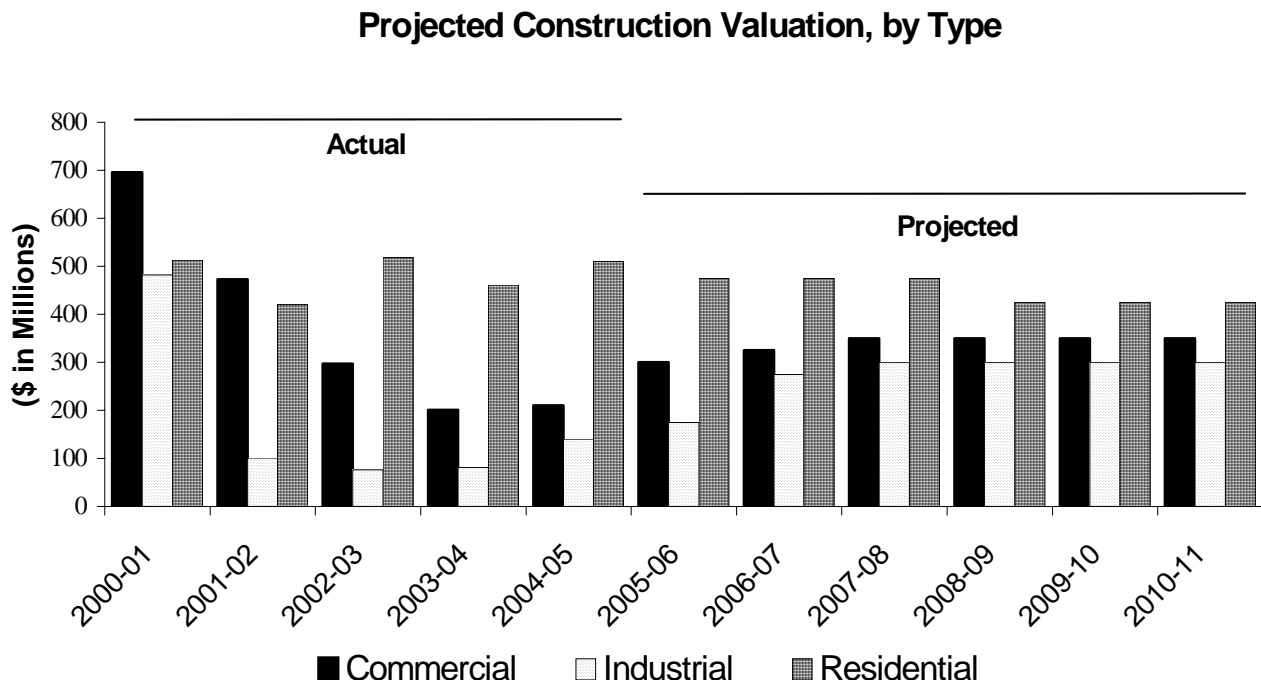
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CONSTRUCTION ACTIVITY PROJECTIONS (CONT'D.)

C. Industrial Construction Activity

Industrial construction activity has experienced a dramatic decline since the peak in 2000-2001. In 2003-2004, permit valuation reached a low point of only \$81 million, well below the peak of \$531 million in 2000-2001. In 2004-2005, a slight recovery was experienced with permit valuation reaching \$140 million. Modest improvement is expected to continue through the forecast period, with permit valuation projected to reach \$175 million in 2005-2006 and increase to \$275 million in 2006-2007 and \$300 million for the remaining years of the Forecast. The total industrial valuation over the forecast is estimated at \$1.48 billion, which is slightly above the \$1.35 billion estimated in the last forecast. As discussed in the report provided by the Planning, Building, and Code Enforcement Department, activity in this area is expected to remain slow with no significant new supply over the forecast period. There are, however, future growth opportunities with companies such as eBay and BEA Systems, both of which have received entitlements for major expansions of their existing campuses.

The following graph illustrates the level of projected construction activity by type (not including exemptions).



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MAJOR DEVELOPMENT ACTIVITY DATA

As part of the Development Activity Highlights and Five-Year Forecast (2006-2011) document prepared by the Planning, Building and Code Enforcement Department, information is provided on development activity that serves as the foundation for their forecast. Data is provided on the major projects (residential projects greater than 50 units, commercial projects greater than 25,000 square feet, and industrial projects greater than 75,000 square feet) and is broken down by the three major land use categories – residential, commercial, and industrial. The projects are further subdivided into four categories based on their status (completed, under construction, approved but not yet commenced, and pending City approval). In addition, individual maps are provided for each of the 15 planning areas in the City that show the projects in all status categories submitted since January 1, 2002. These maps can be used in conjunction with the activity data to help analyze the rate, type and location of major development activity in San José.

BUILDING AND STRUCTURE CONSTRUCTION TAX

The Building and Structure Construction Tax is imposed upon the construction, repair or improvement of any building or structure where a building permit is required. Current rates are:

- 1) Residential - $1\frac{3}{4}\%$ of 88% of the Building Official's valuation.
- 2) Commercial - $1\frac{1}{2}\%$ of the Building Official's valuation.
- 3) Industrial - 1% of the Building Official's valuation.

The proceeds from the Building and Structure Construction Tax are restricted by ordinance for use for traffic capital improvements on major arterials and collectors. These improvements can include the acquisition of land and interest in land and the construction, reconstruction, replacement, widening, modification and alteration (but not maintenance) of City streets. This tax revenue provides the Traffic Capital program with funds to complete major street infrastructure projects, particularly those that improve the Level of Service (LOS). LOS refers to the efficiency with which streets and roadways accommodate peak level traffic.

Based on the construction activity forecasts supplied by the Planning, Building and Code Enforcement Department and an analysis of actual collection patterns, the five-year projection for the Building and Structure Construction Tax collections totals \$50.0 million, with annual proceeds ranging from \$9.7 million to \$10.3 million. The five-year revenue figure represents an increase of approximately \$5.2 million (11.6%) from the estimate included in the 2006-2010 Adopted CIP. While collections are expected to improve slightly over the forecast period, the projected activity levels are still well below the peak. For instance, the 2006-2007 revenue estimate of \$9.7 million is a drop of over 40% from the actual receipts in 2000-2001 of \$17.4 million.

A comparison of the five-year forecast with actual collections in previous years is shown in the chart in the following section.

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CONSTRUCTION EXCISE TAX

The Construction Excise Tax (also referred to as the Commercial-Residential-Mobile Home Park Building Tax) is imposed upon the construction, alteration, repair or improvement of any building or structure, which is for residential or commercial purposes or is associated with a mobile home. This general purpose tax may be used for any “usual current expenses” of the City. However, the City Council has historically used the majority of these funds for traffic improvements. The current rates are:

- 1) Residential - $2\frac{3}{4}\%$ of 88% of the Building Official's valuation.
- 2) Commercial - 3% of the Building Official's valuation.

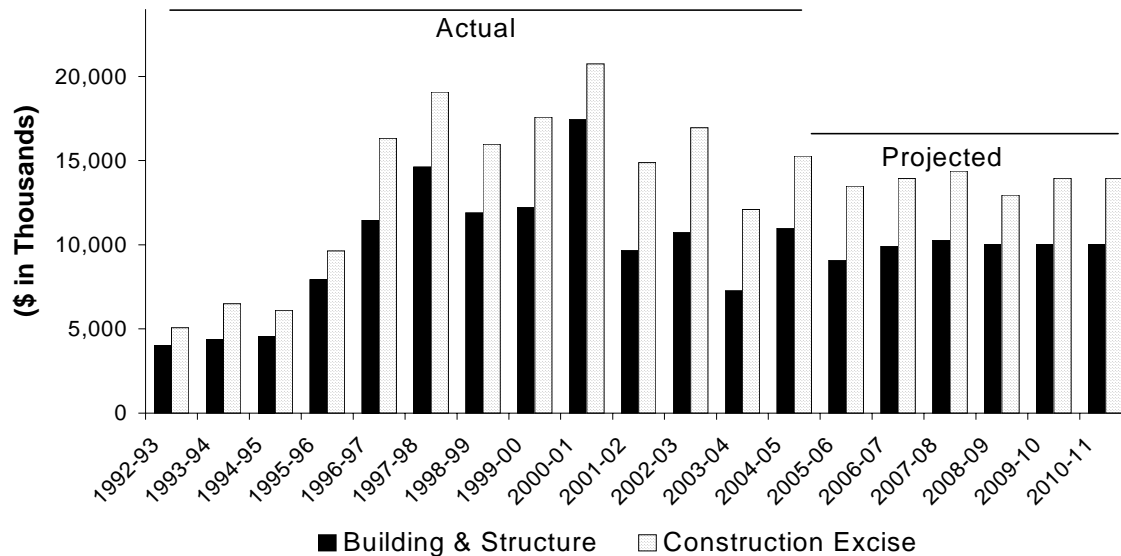
Unlike the Building and Structure Construction Tax, this tax does not apply to industrial development. As a result, changes in industrial building activity do not affect these tax receipts.

This tax is a general fund tax that can be used for any purpose. The majority of the proceeds have generally been used for a variety of essential Traffic Capital projects that cannot be funded by the Building and Structure Construction Tax or grants. Typical projects funded with this tax include street maintenance and resurfacing, streetlights, bicycle and pedestrian facilities, and most strategic planning programs, which improve the City's ability to obtain State and federal grants. A portion of these taxes have also been regularly used to help balance General Fund problems during times of financial stress on that fund.

Based upon the construction projections provided by the Planning, Building and Code Enforcement Department, Construction Excise Tax collections are projected to total \$69.4 million over the five-year forecast period. This collection level represents an increase of \$396,000 (1%) from the 2006-2010 Adopted CIP. This increase reflects the assumptions that residential and commercial construction activity is expected to remain stable over the forecast period.

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Major Construction-Related Tax Revenues



RESIDENTIAL CONSTRUCTION TAX

The Residential Construction Tax is imposed upon the construction of residential dwelling units and mobile home lots in the City. The rates are imposed on each dwelling unit and differ according to the number of units located in the building. Rates vary from \$90 for each dwelling unit in a multiple dwelling of at least twenty units to \$180 for a single-family residence.

This tax is collected and placed in the Residential Construction Tax Contribution Fund and is used to reimburse developers that have constructed a wider arterial street than their residential development required. The funds are also used to construct median island landscaping and other street improvements.

Based upon construction estimates by the Planning, Building and Code Enforcement Department and the actual collection pattern for this tax, \$1.2 million in revenue is expected over the five-year period of this forecast. This amount is slightly above the 2006-2010 Adopted CIP revenue estimates of \$985,000.

SANITARY SEWER CONNECTION FEE

The Sanitary Sewer Connection Fee is charged for connecting to the City's sewer system. The fees collected may only be used for the construction and reconstruction, including land acquisition, of the San José sanitary sewer system. The fee is based on the number of single and multi-family residential units built and the acres developed on commercial and industrial properties.

The 2007-2011 projection for this fee is \$5.7 million, which is a slight increase from the 2006-2010 CIP estimate of \$5.6 million. Collections are expected to remain stable but with very little growth over the forecast period. In addition to being affected by the lack of a significant

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rebound in development activity, this category is impacted by a drop in the amount of projects involving undeveloped parcels for which these fees are assessed. Property that is being redeveloped typically is not subject to the fee.

STORM DRAINAGE CONNECTION FEE

The Storm Drainage Connection Fee is charged to the owner of any land that discharges storm water, surface water or ground water runoff into the City's storm drainage system. The fees are charged by acreage or lot and vary by land use and by the number of units located in the development. Storm Drainage Connection Fees may only be used for the construction, reconstruction, land acquisition and maintenance of the San José storm drainage system. The five-year forecast for Storm Drainage Connection Fees is \$2.6 million, which is consistent with the estimate included in the 2006-2010 CIP. Similar to the forecast for the Sanitary Sewer Connection Fee, collections are expected to stabilize over the forecast period at approximately

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STORM DRAINAGE CONNECTION FEE (CONT'D.)

\$0.5 million annually. The impact of in-fill developments, which are not subject to this fee, continues to affect fee collections.

